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before the

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on

G.I. Finances: Protecting Those Who Protect Us

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Executive Summary

Reports of sales of overpriced, unsuitable investments to U.S. military personnel are unfortunate – and entirely predictable. Current law permits sales loads on sales of periodic payment plans that substantially exceed limits on similarly structured mutual fund products. These excessive sales loads encourage brokers to engage in aggressive sales practices and to sell inappropriate investments. There is no reasonable basis for exempting periodic payment plans from the rules that apply to similar products. Congress should amend the Investment Company Act to authorize the NASD to regulate sales loads on period payment plans.

Chairman Baker, Ranking Member Kanjorski, members of the Subcommittee, thank you for the opportunity to appear before you to discuss the sale of unsuitable and overpriced financial products to U.S. military personnel. It is an honor and a privilege to appear before the Subcommittee again today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law. I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Fund Democracy has attempted to achieve this objective in a number of ways, including filing petitions for hearings, submitting comment letters on rulemaking proposals, testifying on legislation, publishing articles, lobbying the financial press, and creating and maintaining an Internet web site.

I. INTRODUCTION

Recent reports of abusive sales practices on military bases describe a problem that is, unfortunately, not new in the financial services industry. While it is particularly offensive that insurance agents peddle overpriced, unsuitable products to the men and women who daily put their lives on the line for America's defense, it should be recognized that their experiences are not unique. As described in section II of this testimony, the historical parallels to practices that were commonplace in the 1930s are striking.

Congress should promptly take steps to prohibit the charging of excessive sales loads on periodic payment plans. Mutual fund sales loads have long been subject to limits imposed by the National Association of Securities Dealers ("NASD"), whereas sales loads charged on periodic payment plans have been subject to more liberal standards set forth in the Investment Company act of 1940 ("Act"), as explained in

section III of this testimony.¹ As discussed in section IV, periodic payment plans should be subject to the same standards as mutual funds.

There are certain other issues that, while not addressed in detail in this testimony, are illustrated by the reports of sales abuses on military bases and should be considered by the Subcommittee.

First, the Subcommittee should consider the regulation of investment advice on a broad scale. The excessive sales loads mentioned above are unique to periodic payment plans, but the investment advisory problems are not. The inadequate regulation of financial advice provided to military personnel is characteristic of inadequate regulation of advisory services throughout the securities and insurance industry. Brokers who provide individualized investment advice often are not regulated as investment advisers or subject to fiduciary standards, and insurance agents often are not subject even to minimal suitability standards. Both categories of professionals are providing individualized investment advice and accordingly should be held to a fiduciary standard of care.

Second, the Subcommittee should consider how to address the special vulnerability of military personnel, especially junior personnel, to abusive sales practices, whether such practices involve periodic payment plans, life insurance, home financing or any other retail product. The isolated, command nature of military life is a double-edge sword. It creates unique opportunities for the government to protect our soldiers from abusive sales practices, and for salespeople to more easily exploit unsophisticated investors. Sales practices on military bases should be regulated by a centralized office in the military, which should work closely with state securities regulators and the Securities and Exchange Commission (“SEC” or “Commission”).

¹ The underlying investments in which periodic payment plans invest are typically mutual funds. For purposes of simplicity, the term “mutual fund” as used in this testimony refers to mutual funds sold outside of periodic payment plans.

Finally, the financial services industry is regulated under a dysfunctional, smorgasbord of rules promulgated and enforced by a wide variety of state and federal regulators. The reports on sales abuses on military bases illustrate how this patchwork of financial services regulation compromises consumer protection, increases costs, and suppresses competition. Congress should begin a systemic review of financial services regulation with the goal of efficient, functional regulation of all financial services providers and products.

II. BACKGROUND

In the 1930s, the Commission identified problems with the sale of periodic payment plans² that echo the problems identified in a recent series of reports. These plans were designed specifically to appeal to financially unsophisticated investors who could afford only small, periodic investments. Investors paid sales charges twice: once on their investments in the plans and again on subsequent purchases of securities in which the plans invested. These sales charges in some cases exceeded 20% of the amount invested. The effect of the excessive loads was exacerbated by the fact that they were usually “deducted entirely from the payments made in the early months of the installment plan.”³

As discussed further below, Congress has twice attempted to address this problem of excessive loads, but recent reports of sales abuses on military bases indicate that the problem persists. The reports document instances in which only half of an investor’s initial payments into the plans are actually invested, with the agent pocketing the other half. The reports describe the intensive, personal sales practices used by brokers on

² See generally Louis Loss and Joel Seligman, Securities Regulation at §§ 1-H-6(c)(i)(2) & 2-F-2(c) (2004); Tamar Frankel and Ann Taylor Schwing, “Periodic Payment Plans,” 4 The Regulation of Money Managers at § 27.01(B)(6) & ch. 28 (2004); Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, U.S. Securities and Exchange Commission at 382 – 84 (May 1992); Public Utility Holding Company Act of 1935, Release No. 1734 (Sep. 27, 1939) (discussing report on periodic payment plans dated March 31, 1939).

³ Release No. 1734, supra.

military bases that are encouraged by the excessive loads they receive. The unsuitability of the securities and insurance products that are purchased reflects the similarly inappropriate investments made many years ago. Even the practice of specifically seeking to exploit military personnel is a familiar one.⁴

There is also a historical parallel for complaints by firms that they could not afford to operate if they were not permitted to charge excessive sales loads and accelerate the deduction of loads. When Congress first limited sales loads on periodic payment plans, plan distributors persuaded the Commission to grant a temporary exemption from new limits.⁵ The Commission rejected a number of individual requests for exemptive relief, such as one by a company that argued that the new sales load limits would put them out of business.⁶ Recent reports of sales abuses illustrate that some distributors of periodic payment plans have survived and are thriving – at the expense of America’s investors.

III. REGULATION OF SALES LOADS ON PERIODIC PAYMENT PLANS

Federal law generally does not substantively regulate prices in the securities markets, choosing instead to rely on full disclosure and competition to regulate prices. One exception to this principle is the regulation of loads charged on sales of mutual funds, and particularly on shares sold pursuant to periodic payment plans, which have been subject to substantive limits since the federal securities laws were adopted.

⁴ See, e.g., In the Matter of Civil and Military Investors Mutual Fund, Inc., Investment Company Act Rel. No. 2723 (finding that name of periodic payment plan was misleading because it implied that the fund would provide special investment and other advantages, which did not exist, to government personnel).

⁵ See, e.g., Investment Company Act Rel. No. 96 (Mar. 21, 1941) (amending rule N-6C-1 to exempt periodic payment plans from certain limits on sales loads), No. 28 (Dec. 10, 1940) (extending exemption for periodic payment plans from December 31, 1940 to February 15, 1941) & No. 3 (Oct. 25, 1940) (adopting rule N-6C-1 exempting periodic payment plans from, among other things, new restrictions on sales loads in the Investment Company Act until December 31, 1940). The Investment Company Act of 1940 became effective on November 1, 1940. See also In the Matter of Insurance Industries, Inc., Investment Company Act Rel. No. 75 (Mar. 1, 1941) (ordering hearing on request to permit 10% load on periodic payment plan).

⁶ See In the Matter of American Participations, Inc., Investment Company Act Rel. No. 249 (Nov. 5, 1941) (denying request for exemption to permit sales load charges in excess of statutory limits).

Since its inception, the Investment Company Act has limited to 9% the total sales load that can be charged on sales of period payment plans. That limit applies to the sum of all of the payments made during the life of the plan. This is the only express limitation in the federal securities laws on the amount of brokers' commissions.

The Act also restricts the way in which a periodic payment plan sales load is collected. Section 27(a) prohibits: the deduction of more than 50% of the aggregate sales load from the first 12 monthly payments, the subsequent deduction of any sales load that is proportionally larger than any of the initial 12 deductions, and any subsequent deduction that is proportionally larger than any other subsequent deduction.⁷ Thus, the Act permits half of the total payments to be counted toward the sales load until the entire 9% sales load has been paid.

During the 1960s, the Commission reviewed the distribution of periodic payment plans and, finding that many of the abuses that occurred in the 1930s were still prevalent, recommended that sales loads be limited to 5% for all sales of investment company shares. Congress decided to leave the 9% limit on periodic payment plan sales loads intact, but amended Section 27 of the Act to provide additional protection to purchasers of the plans. In 1970, Congress required that purchasers who cancelled the plan within 18 months receive the value of the account plus any sales loads in excess of 15% of the gross payments made. Congress also required that purchasers be provided with a notice of their 18-month cancellation rights and their right to cancel the plan within 45 days of receipt of the notice and receive the value of the account plus all sales loads ("cancellation notice"). Alternatively, a plan was not required to provide the 18-month withdrawal option if it deducted no more than 20% of any single payment, and on average no more than 16% of the first 48 monthly payments.

⁷ The original version of Section 27 actually required that remaining sales load deductions after the first year be spread proportionately across the life of the plan, see Loss § 2-F-2(c), supra note 2, but this requirement was weakened when Congress amended Section 27 in 1970, as discussed below.

In the same legislation that added these provisions, Congress specifically authorized the NASD to adopt rules prohibiting brokers from charging “excessive sales loads” on the sale of investment company shares. The NASD subsequently imposed limits on such sales, but these did not apply to periodic payment plans.⁸

NASD Rule 2830 provides that any sales charge in excess of limits enumerated in the Rule shall be deemed excessive. The maximum sales charge under the Rule is 8.5%, which must be reduced depending on whether dividends are reinvested without incurring an additional charge, minimum discounts are available for large purchases, and/or asset-based distribution fees are imposed. In practice, sales loads rarely exceed 5.75% and are often substantially lower.

The difference between the statutory and NASD limits on sales loads is dramatic. To illustrate, if a purchaser bought a periodic payment plan that provided for payments of \$100 per month for 10 years, the total sales load would equal \$1,080, and that entire amount could be deducted during the first 22 months of the plan. If the purchaser cancelled the plan within the 45-day cancellation period, he would receive the value of the account plus all sales load payments. If he canceled within 18 months of the purchase, he would receive the value of the plan plus \$630 and would have paid an effective sales load of 15% (\$270) on the aborted investment.⁹ If he canceled after 19 to 21 months, he would not be entitled to a refund of any of the sales load, which would result in an effective load of 50%.¹⁰

⁸ The NASD presumably did not apply its rules to sales loads paid on periodic payment plans out of deference to the specific limits on such sales loads in the Act, which limits had been amended at the same time that Congress granted the additional authority to the NASD.

⁹ The purchaser would have paid \$900 in sales charges ($.5 * \$100 * 18 = \900). The distributor would be entitled to keep 15% of the gross payments of \$1,800, or \$270. See generally Diana B. Henriques, Basic Training Doesn't Guard Against Insurance Pitch to G.I.'s, New York Times (July 20, 2004) (one of every four First Command plans is cancelled before completion).

¹⁰ For example, after 19 months the purchaser would have paid \$950 in sales charges ($.5 * \$100 * 19 = \950) out of gross payments of \$1,900.

In contrast, NASD rules provide that a purchaser of shares of a mutual fund would never pay more than an 8.5% sales load, and in most cases would pay substantially less, even if the investor sold the investment after a short period. The following table illustrates the difference in permissible sales charges, using a 5.75% front-end sales load, which is typically the highest load charged in the mutual fund industry.

Table A: Comparative Sales Loads

| | Periodic Payment Plan | | Mutual Fund |
|---|-----------------------------|-----------------------------|-------------|
| | Option A: 50% Maximum | Option B: 20% Maximum | |
| Cancellation within 45 days of receipt of cancellation notice | 0% | 0% | 5.75%* |
| Cancellation within 18 months | 15% | 16% | 5.75%* |
| Cancellation after 19 to 21 months | 50% | 16% | 5.75%* |
| Cancellation after 22 or more months | 9% - 50% | 9% - 16% | 5.75%* |

* Load funds often offer a share class that imposes a deferred sales charge that declines the longer the shares are held, as well as a share class that imposes a substantially lower asset-based sales charge. For example, an investor that sold his shares after one year might pay a deferred sales charge of 4.75% or asset-based sales charges of 1.00%.

Thus, periodic payment plans and mutual funds are subject to very different restrictions on sales loads. Brokers who sell interests in periodic payment plans are permitted to charge substantially higher loads than those who sell mutual funds, and loads on periodic payment plans can be collected on an accelerated basis. As discussed in the next section of this testimony, there is no reasonable basis for such differential treatment.

IV. ANALYSIS AND RECOMMENDATIONS

Some have argued that a high-level, accelerated commission structure is necessary to pay for the cost of selling periodic payment plans. The theory underlying this “cost” argument is presumably that it is more expensive to service the kind of investor to whom periodic payment plans are sold. Periodic payment plans are typically

sold to investors with limited means who cannot afford to make large, lump-sum investments. The smaller contribution amounts therefore generate lower commissions to cover the sales costs. If payment of sales loads could not be accelerated, full recovery of distribution costs would take years, thereby reducing the incentive to sell the product. In addition, investors with limited means also may be more likely to cancel a plan, thereby leaving the distributor with an even smaller commission if accelerated deductions are not allowed.

This rationale may have made sense years ago, but it is directly contradicted by current mutual fund sales practices. Load mutual funds routinely provide for systematic investment plans where the investor invests a small amount every month and is assessed an NASD-regulated load only on that amount, thereby suggesting that brokers find these sales to be sufficiently remunerative. In many cases, the sales load charged is well below the NASD's legal limit. These plans typically permit the investor to aggregate the total payments in order to qualify for commission discounts for larger purchases, which further reduces the sales load. Thus, for years load mutual funds have offered systematic payment plans subject to NASD limits on sales loads, thereby refuting the argument that applying these limits to periodic payment plans would not be profitable.

Some mutual funds have investment minimums that are \$500 or less, which means that the broker selling the fund shares may receive only about \$25 on the purchase, with no guarantee of any additional commissions on follow-on sales. If that one-time \$500 investment had represented five \$100/month payments in a periodic payment plan that was canceled after five months, **the broker's commission would be 300% higher.** Similarly, if a mutual fund broker can survive on a \$100 commission on a \$2,000 investment, why does a broker need a \$1,000 commission when the same \$2,000 investment is made through a \$100/month periodic payment plan that is canceled after 20 months? In each case, the shareholder invests the same amount over the same period, **but the commission paid to the broker for the periodic payment plan is 1,000% higher.** The Commission's description of periodic payment plans sold in the 1930s

continues to apply today: “[i]n the early stages of plan participation, an investor receives little more than the opportunity to pay excessive sales loads on initial payments.”¹¹

Many mutual funds collect sales loads through low-level asset-based fees, known as 12b-1 fees. For example, a purchaser of a mutual fund’s Class B shares (usually considered the most expensive, least suitable class for a typical investor) might pay only 1% annually in 12b-1 fees, which would not cover actual distribution costs for a number of years. The distributor is able to pay the broker an upfront commission, however, by borrowing the payment from a bank or other lender and using the expected income stream from the 12b-1 fees as collateral.¹²

The difference between the amount of commissions paid when a mutual fund charges a 12b-1 fees and when a periodic payment plan is used is dramatic. For example, if the investor bought \$100 worth of mutual fund shares every month for two years, he would pay about \$25 in distribution fees assuming a 1.00% asset-based fee (or \$120 assuming a 5% front-end load). If the same investor had invested through a periodic payment plan, he would have paid \$1,080, **or approximately 4,320% more in commissions.** The introduction of 12b-1 fees, rather than impeding the sale of mutual funds, is partly responsible for the enormous growth of the mutual fund industry over the last two decades.

Thus, neither the 9% sales load limit nor the ability to accelerate the payment of the sales load can be justified in light of current sales practices in the mutual fund industry. Mutual fund brokers frequently sell to investors who are similar to investors in periodic payment plans, yet they charge sales loads that are often a small fraction of the sales loads that Congress permits for periodic payment plans.

¹¹ Protecting Investors, *supra* note 2 at 390 – 91.

¹² See generally Rochelle Kauffman Plesset and Diane E. Ambler, The Financing of Mutual Fund “B Share” Arrangements, 52 Bus. Law. 1385 (August 1997).

If the higher, accelerated sales loads are not needed to sell periodic payment plans, then what is the explanation for such loads? The logical explanation is that the extra compensation is funding precisely the kind of aggressive sales tactics that prompted Congress to substantively limit sales loads on periodic payment plans over 60 years ago. As the Commission has noted, the problem of excessive loads was “inextricably related to the [intensive] method of distributing certificates.”¹³ The more a salesperson is paid for selling a product, the more money and effort the broker will expend on sales activities, and the more shares the individual broker will sell. The amount of the permitted sales load drives the sales expenditures, not the other way around.

This explanation is consistent with the evolution of load mutual funds and periodic payment plans. Where sales loads are subject to NASD limits, mutual fund assets, including assets invested pursuant to systematic investment plans, have grown enormously over the last 25 years. Competition has consistently reduced distribution costs such that the highest sales loads are typically well under NASD limits. In contrast, overpriced periodic payment plans have a relatively small asset base. Sales of periodic payment plans is quite remunerative for the niche players who sell them, but their cost structure limits their growth potential.

The relative success of sales of periodic payment plans to military personnel is virtually assured by their sales structure. The sales structure encourages brokers to engage in precisely the kind of personalized, affinity sales practices described in the reports on periodic payment plans sales abuses. The intensive use of “education” seminars and social gatherings, the exploitation of the implied authority of brokers who are retired military personnel, and limited access to the military market all combine to create an artificial, niche market where the sale of high-priced, aggressively marketed products will thrive.¹⁴

¹³ Release No. 1734, supra note 2.

¹⁴ See Basic Training, supra note 9.

This market also insulates brokers from regulatory scrutiny, as the military is not well-suited for regulating financial services, as this is not its primary mission. Yet the military actively exercises authority over on-base sales practices, which gives the impression that it approves of financial products that are sold on-base.¹⁵ Military regulation also creates uncertainty as to who is the appropriate rulemaking and enforcement body and naturally deters state and federal regulators from intervening. The mobility of military personnel and the location of many bases abroad further exacerbate the regulatory vacuum.

While improvements in the oversight of on-base sales practices would reduce the degree and frequency of abusive sales practices, the level of compensation paid to brokers who sell periodic payment plans virtually assures that abusive sales practices will be more egregious and frequent than for other products. Current limits on sales loads on periodic payment plans provide brokers with a powerful economic incentive to engage in aggressive sales practices and to sell unsuitable investments. When regulators are not looking, these pressures will inevitably result in the continuation of abusive sales practices and the exploitation of military personnel.

As recent reports on sales abuses on military bases indicate, these abuses have been a persistent problem for years,¹⁶ and a structural solution is necessary. Congress should authorize the Commission and the NASD to adopt rules regulating the sale of periodic payment plans, and repeal existing limits on sales loads charged on sales of periodic payment plans as of the adoption of such rules. Such legislation should state expressly that restrictions on sales loads for periodic payment plans and similar products should be the same unless the basis for any difference has been fully documented and

¹⁵ As one member of this Subcommittee was quoted saying: “When the Pentagon lets these things be sold on base, it’s implicitly saying these products are O.K., and they’re not O.K.” Diana Henriques, *Sales of Investments to G.I.’s Under Scrutiny* in Washington, N.Y. Times (July 22, 2004) (quoting Representative Rahm Emanuel). See also Basic Training, *supra* note 9 (“When we allow a person on an installation,” Mr. Molino[, deputy under secretary of defense for military community and family policy,] said, ‘there is at least the implication that we have sanctioned your presence.’”)

¹⁶ See Basic Training, *supra* note 9 (citing reports prepared in 1997, 1999, and 2000, and abuses described in article in The Army Times in 1974).

reported to this Subcommittee.¹⁷ Such reforms are necessary to help our soldiers benefit from the free market system they are fighting to defend.

¹⁷ Accord Protecting Investors, supra note 2 at 405 – 406 (recommending that Congress adopt a reasonableness standard for insurance products that would “approximate the standard for regulation of mutual fund sales charges” as imposed by the NASD).